SMALL BUSINESS ADMINISTRATION
Asset Sales Program
Highlights from the Draft Strategic Plan

I. Introduction

The Small Business Administration (SBA) provides assistance to small businesses through a variety of financial and non-financial programs. SBA's biggest contribution to small businesses is achieved through a variety of guaranteed loan programs. As of September 30, 1996, the total investment under SBA's Financial Assistance Programs amounted to $35 billion. The outstanding SBA guarantees exceeded $26 billion (Figure 1) and the total outstanding loans serviced by SBA exceeded $9 billion.

Figure 1

BORROWER CLASSIFICATION	OUTSTANDING BALANCE (000'S) (SBA Share)
Individuals	$ 7,490,252
Partnerships	2,526,796
Corporations	16,346,917
Unspecified	117
Total	$ 26,364,082

Generally these loans are small (74% are under $250,000) and are made to support a wide variety of business enterprises, particularly Retail Trade and Services which together account for 61% of the total loans outstanding. The collateral for this credit is more concentrated in personal and business assets, and subordinate liens, rather than in real estate mortgages.

SBA loans are originated by approved SBA private sector lenders and by SBA directly. Most are originated by private lenders which also service the loans so long as the loans are current (i.e., payments are being made in accordance with the loan agreement). SBA guarantees a portion of each loan depending on the program and the amount of the loan. The major programs are summarized as follows:

PROGRAM	**GUARANTEE STRUCTURE**
7(a) under $100,000	Pari Passu SBA 80% guarantor (proportionate share with Lender)
7(a) $100,000-$750,000	Pari Passu SBA 75% guarantor
FASTRAK	Pari Passu SBA 50% guarantor
504	Tiered: 10% Equity, 50% First Lien Lender, 40% SBA guarantee

Currently, under the 7(a) guaranty loan program, the SBA is authorized to provide guarantees ranging from 75 to 80 percent on loans made by private lenders, with the average guaranty being approximately 76 percent. Approximately 7,000 banks and non-bank lenders are now approved to participate in the SBA guaranty loan program. Generally, with some specific program exceptions, SBA guarantees are generally limited to $750,000 or a lesser amount of a loan. The proceeds from an SBA guaranteed loan may be used for virtually any business purpose.

Under the 504 program, SBA guarantees debentures that provide long-term, fixed rate financing for the acquisition of fixed assets. SBA's participation in the project is limited to 40 percent of the total project cost. The borrower is required to make an investment of at least 10 percent of the project costs with the remaining 50 percent coming from a private lender that normally takes a collateral position superior to that of SBA. The 504 program cannot be used for working capital.

The SBA services loans directly when one of two events occur:

1. A loan defaults and the SBA purchases the loan according to the terms of the guarantee and the lender does not wish to retain servicing of the loan.
2. The SBA itself originates the loan.

As of February 28, 1997, the SBA was servicing 304,967 loans with a principal balance of $9.1 billion. As can be seen from the following table, the major SBA direct loan interests are for disaster home loans and disaster business loans.

PROGRAM	**NUMBER OF LOANS**	**BALANCE ($ mil)**
7(a)	17,295	$1,855.2
504	1,264	209.9
Disaster	286,408	7,037.7
Totals	304,967	$9,102.8

The Administration's FY 1998 budget proposes that SBA begin selling loans that currently are assets of the SBA and to begin the process of making the transition from direct servicing of loans to becoming an overseer of private sector servicers. The specific proposals of SBA's budget are:

- delegate remaining 7(a) servicing and liquidation to lending partners
- sell all 7(a) and 504 loan assets by FY 1999
- complete Pilot Sale of $100 million in Disaster Loans
- sell all Disaster loans by FY 2000

These features of SBA's budget reflect the Administration's commitment to the recently enacted Debt Collection Act, which promotes loan sales and privatization of asset servicing and other credit functions that have an analogue in the private sector.

SBA program volume has increased by 189 percent between 1988 and 1996 while staff levels decreased by 23 percent during the same period. That contrast is indicative of the changing environment now requiring SBA to transform itself. The trends over the past nine years support the same conclusion: a 23 percent decline in agency staffing (measured in FTEs) while the volume of loan approvals increased almost threefold.

The consequent transformation of SBA's lending business is underway. It includes greater devolution of many of the loan processing, servicing, and liquidation functions from the SBA to SBA's private sector lending partners. As Administrator Aida Alvarez has stated, the SBA will do business in a new way: "We must change from an organization that processes loans to one that oversees and monitors lenders."

The Government Performance and Results Act (GPRA) is moving all agencies to reexamine their mission and in these times of balanced budgets and diminishing resources, to put forth a renewed commitment to maximizing results. SBA can best achieve its objectives of providing small businesses access to credit and providing assistance to victims of natural disasters by dedicating resources to the loan origination, training, and management aspects of the business assuring that small businesses have access to SBA products and services. Asset sales can free up resources for such functions. These changes will allow SBA to provide more loans to its customers and better, more sophisticated service. But the process must be carefully managed.

The new SBA with its increased programs and activities will place new demands on the dedicated staff of SBA. In these times of tight budgets, the resources to achieve increased and improved levels of services must come from savings in SBA operations. The Asset Sales Program is part of the larger strategy of SBA to better serve the small business community so small business can continue to play its critical role in the American economy. This is achieved in two primary ways: (1) shifting resources to increase small business access to capital and other SBA products, and (2) achieving budgetary savings for the taxpayer. It may also be that the Sales Program will have design features that appeal to small investors.

Asset sales can be an important tool for SBA's transformation. By freeing staff and resources from the loan workout and collection processes, SBA staff and resources can be concentrated on the core missions of SBA -- providing credit and management, technical and procurement assistance to America's Small Business.

This Draft Strategic Plan summarizes the recommendations of the strategic planning team about a sound approach to the challenge of implementing an Asset Sales Program for the $10 billion in SBA-owned loan assets.

It is recommended that once SBA is satisfied with the direction, the Draft Strategic Plan be circulated to stakeholders for their review and comment. Asset sales represent a significant change to the traditional way that SBA does business; a transparent process and responsiveness to stakeholder concerns is prudent. The stakeholders at the core of the SBA's mission -- the small business owner -- will also be addressed through an aggressive sales marketing campaign that should include specific outreach efforts, such as investor seminars.

Careful study of the attachments (for example, the discussion of alternative sales structures used by the RTC in Attachment 2) can give the reader a sense of the options available. The strategic planning team believes it is prudent to determine specific sales structures and related timelines, once the agency and its Program Financial Advisor have a full understanding of the assets to be sold.

SBA had earlier retained an advisor to examine the assets and recommend ways to sell them. What seems most appropriate is for the agency to hire a Program Financial Advisor, one who will not do the transactions and is not compensated on the transaction success. Instead, this advisor would be retained for three years, perhaps with an option for subsequent renewal, and would advise the agency on the overall program. This Program Financial Advisor would review the collection histories that are available, the condition of the files, distribution of product geographically, and when coupled with an examination of market factors and interest, would recommend a rollout of the series of sales that achieve SBA's objectives. The Program Financial Advisor would also be available, at the request of SBA, to assist with other sales-related tasks such as assisting SBA staff in the development of appropriate models for credit reform valuations, maintenance of the Sales Handbook of lessons from each transaction, and development of content for the sales website presence on the Internet.

II. Recommended Asset Sales Process

The steps for SBA to implement its Asset Sales Program can be summarized as follows:

1. Select a senior executive who will champion and oversee the program inside SBA.

Implementing change of this magnitude can only be accomplished and success ensured if there is a senior executive driving the program. This executive needs the authority to make the tough decisions to advance the program, keep staff focused on the desired results, and establish credibility in the marketplace. The importance of having this role filled right from the outset cannot be overstated.

2. Identify and prioritize the desired results from the program.

Asset sales programs within the government face the challenge of balancing a number of interests, some of which may appear to be in conflict. Successful implementation and sustaining momentum requires the agency to be clear with the sales team as to desired results priorities. SBA needs to identify its position on these issues, for example:

- preserving public purpose objectives
- maximizing the net present value return
- disposing of assets in a timely manner
- reaching largest pool of investors
- maximizing the negative credit subsidy
- managing the impact on agency staffing and organizations
- coordinating with existing contracting-out programs
- assessing the impact on existing centralization programs
- establishing the framework and procedures for future sales

SBA is considering a variety of structures, including Portfolio Sales, wherein SBA has no interest in the assets or the collection stream post-sale; Retained Interest Sales, meaning that SBA shares in the potential upside of loan recoveries; and Joint Venture Transactions, referring to structures that would form a new entity – a type of partnership – and SBA would be a limited partner in that partnership.

The choice between a Portfolio Sale and a Retained Interest Sale, for example, depends upon the agency's judgment about the relative merits of several factors. The Retained Interest Sale may generate better returns than the Portfolio Sale. Also, the Retained Interest Sale may permit easier solutions to some of the public policy issues involved in servicing the loans post-sale. On the other hand, the Portfolio Sale is easier to implement, permits participation by more and smaller sized financial firms, and will permit SBA to reach out to small investors more extensively than can be done in a retained interest sale.

3. Decide on the initial target pool and type of transaction.

To minimize risk, familiarize SBA staff and external stakeholders to the sales process, and to avoid delay in launching the program, initial transactions should make use of transaction models developed and proven by other agencies. The next section outlines an order of priority and options for selection of assets for sale.

The experiences of the Resolution Trust Corporation (RTC) and the Department of Housing and Urban Development (HUD) are especially relevant. The marketplace for the disposition of non-performing and formerly defaulted loans and repossessed assets has become efficient in recent years. That market was developed by the RTC; it was further enhanced by HUD, and SBA can build on those successes and lessons learned.

Identification of asset type and transaction type for initial transactions is an extension of the strategic planning process and can best be completed by the Program Financial Advisor earlier mentioned. For this early stage of implementation, SBA can enhance its control over the process and save time and money by using consultant assistance paid on an hourly basis, or paid by fixed fee for defined tasks. It is not appropriate for this type of advisory service to use a compensation structure based on the transaction type, size, or success.

If one phrase can be used to characterize the initial implementation, it is *keep it simple and ensure success*. There are a multitude of decisions to be made and challenges to be overcome to implement a sales program at any agency. Both RTC and HUD started with more simple, whole loan sales (portfolio sales) as the preferred method to launch the program. A determining factor is the disposition schedule, and if the volumes in the Administration's budget cannot be restated, then a harder look at the accelerated use of Retained Interest sales is warranted. This is due to the fact that a higher volume of assets can be done in a Retained Interest sale.

As one can see, there are trade-offs to be made depending on how the agency determines to best balance the competing objectives. Portfolio sales for the 7(a) and 504 loans will reach the broadest possible audience of bidders, are easiest to implement, most familiar to the marketplace, and would generally be in the range of $500-$750 million (in Unpaid Principal Balance or "UPB") per sales event. Retained Interest Sales have the potential of generating higher returns for the agency, allow recovery over a period of time rather than upfront, may provide a vehicle to better address the complex public policy issues surrounding the servicing of the loans post-sale, and can support higher UPB volumes in the individual sales events. There are potential disadvantages to the Retained Interest Sales, including the uncertainty of receipts to be collected over time due in part, to changing economic conditions. Additionally, there is a possible "alter ego" challenge, where it may be perceived that SBA can control the disposition activity due to its continued role in the joint venture (albeit a passive role).

The Disaster Loans are quite different in that it is assumed the loans in this portfolio have common characteristics and may be better suited to larger events. They are smaller average loan sizes and pose different public policy objectives. HUD sold single family mortgages of an average size of $45,000 UPB in sales events up to $900 million (and did not feel constrained from going even higher).

Starting with a Portfolio Sale, followed immediately by a Retained Interest Sale, and maintaining an aggressive sales timeline may make the most sense for SBA. As was earlier noted, the inventory of 7(a) and 504 loans of SBA is just over $2 billion, and expectations are that there will be a net addition to the portfolio of about $400 million annually over the next few years.

A significant aspect of the program launch that should not be overlooked is educating the marketplace on the *entire program*. A key aspect of HUD's success *right from the first sale* was the massive commitment to educating investors on the agency, the type of assets, and the agency's resolve to a successful implementation. This is another area where the Program Financial Advisor is invaluable. Establishing and maintaining a presence in the marketplace and *marketing the program*, not just the sales events, is necessary to achieve the best results.

Figure 3
Alternative Forms of Asset Sale

	Advantages	Disadvantages	Comments
Sales of whole loans	Good for assets that can be valued by investors in a typical due diligence environment Easiest to execute Most user-friendly to unfamiliar stakeholders Reaches largest market of potential bidders	The agency retains no ability to participate in improved loan performance Complexities of servicing for public purposes are more difficult and/or costly to achieve	RTC started with these transactions HUD started with these transactions
Loan sales/ government retains subordinated debt (i.e. takes first losses)	Good when the market would underprice because of inadequate due diligence	Transactions costs can be high; investors often require "AAA" rating on the debt they buy Not user-friendly for the small investor	Publishing the payment experience on the subordinated debt can improve pricing on later deals
Securitization/ government keeps some equity and sells some equity and possibly debt	Good for investment grade product where the arbitrage can be maximized quickly Creates a marketable, transferable liquid instrument	High transactions costs Must maintain credit enhancement; continuing role for the agency	HUD has refined this structure to serve public purposes

Equity partnership	Good for below investment grade portfolios; government can get some cash immediately and also participate in gains, if returns from servicing improve	Not user-friendly for the small investor Political perception is that SBA is still involved; may be more apparent than RTC	Small workforce needed for equity monitoring (either directly or via contracted resources) Both the RTC and HUD can be benchmarked to determine best practices in equity monitoring via contractors Not as cost-effective for investment grade portfolios as whole-loan sales
Governmental securitization/ government guarantees all securities	Low transactions costs; avoids perception of low returns; allows privatization of servicing	Government retains financial exposure and must manage its risk	This is the Vinnie Mac structure (for VA vendee loans)

4. Identify Asset Sales Program Team.

A small team of up to ten people, located centrally, is needed to manage, oversee, and be responsible for the asset sales results. After consultation with SBA, it seems reasonable to begin with a couple of people and when the program is ready for implementation, quickly build to six staff. The team should be assembled consistent with the timetable for bringing on the senior executive who will be championing the program. This team should be viewed as consisting of the facilitators or drivers who do what needs to be done to move the program forward. Initially, they may play an extensive role in getting the contracting solicitations completed; they will be sales agents within the agency to assist in getting the staff buy-in; and they can provide valuable insight to the team of contractors who will require education on SBA. The team will also be responsible for assuring that financial responsibilities of budgeting, budget scoring, reporting and evaluation of results are managed fully and competently.

The team will primarily be persons interested in and capable of managing financial transactions, and should include representatives of the various areas within SBA that are necessary to complete the sale. For example, participation from the Program area, loan accounting, information technology (development and maintenance of a marketing site on the Internet), perhaps Budget, and from the SBA counsel's office, will be vital. With assistance of contract advisors on the program overall and on the individual transactions, whose scope includes training SBA staff, the career team members can become fully qualified to carry out these responsibilities in the future with decreasing contract assistance.

This team could also benefit from short-term details of personnel who know the sales programs at FDIC and at HUD if available. This valuable resource should be considered as a way to build the institutional knowledge quickly.

It is also important to note that the senior executive championing the program will need to reach out to a circle of partners within the SBA whose support is necessary to achieve the desired results. This team of partners will undoubtedly include the Office of Procurement & Grants, the Office of the Chief Financial Officer (OCFO), Office of General Counsel (OGC), as they play a significant role in implementation, and should also include Congressional Affairs and the Inspector General's Office. While in-house legal support has already been mentioned as a necessary component of the successful sales team, the departmental support for the program is so important that it deserves another mention. The requirement to complete a solicitation for outside legal counsel has to be done as rapidly and on the same timeline as for the other contractors. Orienting new counsel to SBA while at the same time learning the sales business, will be time intensive for 1-2 legal staff.

5. Engage the Outside Advisors.

Four different types of advisors are recommended to support the Asset Sales Program – a Program Financial Advisor, Transaction Financial Advisors, Due Diligence Contractors, and Outside Legal Services providers – and with the exception of the Program Financial Advisor, multiple contractors should be engaged in each category. There has been some experimentation (at HUD for example) with the seller engaging only one contractor, who in turn hires the other disciplines necessary to complete a transaction. This approach reduces the impact on the Office of Procurement, no doubt, but it does not create the best results for the agency overall. These roles are different -- program design, sales structure and execution, asset due diligence, legal advice and support -- and it is in the best interests of the agency to have each of these disciplines reporting *directly* to the agency. Such a practice avoids any possibility of a conflict between the parties, real or perceived, or in the performance of their duties.

- ***Program Financial Advisor***

Only one Program Financial Advisor will be needed to serve in this role and it should be engaged for a 3 year contract life (perhaps with one year options to extend thereafter). The Program Financial Advisor will examine the entire pool of assets and the servicing environment, and with its knowledge and interaction with the market, will recommend the rollout of transactions which will become known as the SBA Asset Sales Program. This role also includes market education and an extensive program marketing role that can be thought of as strategic communications. Compensation for the Program Financial Advisor can be on an hourly basis or fixed fee for specific tasks and deliverables.

- ***Transaction Financial Advisors***

In this solicitation, SBA should be looking for a number of qualified financial advisors (the recommendation is to select four), each of whom is fully capable of executing the full compliment of sales structures. The initial solicitation could have two components to it: (1) Technical Proposal to be a Transaction Financial Advisor and join the pool of TFAs to the agency, and (2) a Technical and a Cost Proposal to complete a Portfolio Sale of approximately $500 million UPB.

Including the Portfolio Sale transaction as part of the solicitation itself will allow SBA and the sales team to kickoff the first sales event immediately upon award, rather than beginning another cost bidding after selection of those technically qualified. Work should also start quickly on the initial Retained Interest Sale which will require longer lead time than the Portfolio Sale and will follow the first Portfolio Sale. Most likely two different contractors will be chosen for the initial Portfolio Sale and for the initial Retained Interest Sale.

There is an argument to be made for starting with smaller sized transactions. Initial transactions in the $200-$400 million range might be more comfortable for developing a new program, setting precedents, and getting the staff and market oriented to the program. The strategic planning team pushed the parameters to the outer limits in an attempt to accommodate the OMB sales targets.

The Transaction Financial Advisors are typically paid in one of three ways: hourly, percentage of sales proceeds, or percentage of UPB. The hourly model may be more typical for the agency, but it does not lead to the best alignment of incentives. Payment based upon sales proceeds, on the surface, seems to align the interests of getting the best price for the services. However, it can also promote adverse behavior on the part of the Transaction Financial Advisor, particularly in government settings, where public policy objectives have real value. UPB also seems to align the interests and it does not have the potential of rewarding adverse behavior to the agency, but the significant downside is that it does not incentivize outstanding performance.

- ***Due Diligence Contractors (DDC) and Outside Legal Services (OLS)***

Like the FA's, the solicitations should aim to select a variety of technically qualified companies. Please note also that these are *separate solicitations.* The nature of this work means that it has traditionally been paid on a hourly fee basis. The experiences from RTC and from HUD strongly supports that the DDC's be engaged by the Program Office and the OLS by internal counsel.

As with the FA recommendation, the desired results from the initial solicitations are to select the pool of contractors for the Program overall, <u>and</u> to get cost proposals on the first two transactions (a $500 million Portfolio Sale and a $750 million Retained Interest Sale).

To embed the sales process within the SBA culture, an objective should be to train staff to complete the due diligence internally (with perhaps a final sign-off from the DDC). Part of the due diligence contractor solicitation could be requirement to train SBA staff to complete due diligence for future transactions. The FDIC's Dallas Service Center has the most recent volume experience with small asset sales that would have some similarities to SBA assets. That office's successful use of in-house due diligence should be examined and perhaps modeled.

While these are four different solicitations (Program Financial Advisor, Transaction Financial Advisor, Due Diligence Contractor, Outside Legal Services), they must be run simultaneously, to keep the sales timeline on target. This presents an enormous challenge for those involved in the contracting process.

6. Begin the Sales Handbook and Commit to its Development and Maintenance throughout the Life of the Asset Sales Program.

For a seller who has a goal of embedding the sales processes into its work culture and learning how to perform many of the services itself, a Sales Handbook should be developed. HUD used this process (called the Design Book) and it leveraged its resources well. The HUD guide should be examined as a starting point for the SBA financial advisors.

Key to the Sales Handbook effectiveness is <u>accessibility</u> and <u>buy-in</u>. It should be widely circulated to the various disciplines and their comments should be carefully examined for conclusion; and in any event, should be resolved. SBA should consider making the Handbook available electronically and in website format, increasing ease of use for SBA staff and for the roster of contractors involved in the sales process.

7. Conduct Seller Due Diligence.

The FA should determine what data elements should be collected on each loan for the SBA and potential bidders to analyze value. A credit scoring model for all borrowers whose loans are contained in the portfolio prepared for sale might be examined as a possibility. Credit scores may be able to provide substantial information to investors at relatively low cost. To the extent repayment is based on an individual's credit, this idea has merit; however, repayment coming from business sources would not lend itself to the established credit scoring models. The Financial Advisor will advise on the best method to assemble information and files for marketing and bidding.

8. Conduct Marketing and Buyer Due Diligence.

Marketing occurs on three levels:

- public
  - advertisements, pamphlets, sales books, etc.
- direct
  - targeted mailings to other government investor databases
- electronic
  - making as much information as possible available through the web

The Transaction Financial Advisor will market the transaction, prepare bid packages, and help oversee bidding. The sales team (including the Program Financial Advisor) should establish a website presence at the outset and post up all information that can be made available to the general investing public. Of particular note should be a Q&A package that can address the most frequently asked questions. In addition to being a vehicle to answer the public's questions, the website serves as an "electronic library" of the documents and position papers for the SBA staff and their contractors.

9. Timelines.

The contracting process and due diligence are the most lengthy functions. Once SBA decisions have been made and the team of contractors are engaged, it should take four to six months to close a transaction (depending on the amount of pre-due diligence that has been completed)**.**

The financial advisor engaged to examine the portfolio and recommend the rollout of the sales events should provide an overview of a timeline for each of the transactions. Two draft sales timelines have been considered. The first timeline is an aggressive approach from the strategic planning team and it provides for liquidation of the entire portfolio (assumed to be in the range of $10.6 billion) by June, 2002. Recognizing the budget mandate, a second timeline of an even more accelerated approach was prepared and it demonstrates how the portfolio disposition could be completed by May, 2001. Forecasts for sales events that far in the future are challenging and until the Agency gets one or two transactions completed, these forecasts should be used as a guide only. It does reveal however, that neither approach achieves OMB's direction in the FY 98 Budget. As reality is likely to produce timelines that are even longer than projected in these forecasts, SBA needs to engage OMB on their expectations.

Individual sales transactions, whether Portfolio Sales or Retained Interest Sales, generally follow a 5-6 month timeline as outlined below:

- Conduct due diligence — 8 weeks
- Seller marketing and buyer due diligence — 6 to 8 weeks
- Closing and transfer of servicing — 4 weeks
- Lessons Learned and Sales Handbook — 4 weeks

NOTE: As was earlier indicated, as part of rolling out the first sales event, the marketplace education has to be carefully structured and implemented. Maximizing the sales price of the assets is directly tied to the marketing of the *program,* in addition to individual sales events. The SBA mission, the introduction of a new sales program, and the nature of the assets makes a series of Investor Seminars particularly attractive. These Seminars could be thought of as outreach to the investing public, including the small business owner, and should be conducted in areas where the SBA assets in a sale are most prominent.

One potential way to build more capacity and speed the sales timeline, without placing an undue burden on the core Sales Team, is to permit sales to happen in the Field. At some point after the initial transactions, SBA and the Crosscutting Advisor should look at whether the authority can be delegated, and what the pros and cons would be to further embed disposition in the culture.

10. Closing the Sale.

The RTC, FDIC, and more recently HUD, have evolved the closing process on government sales to an efficient state. The design is usually geared to push as much obligation on the buyer as possible, without exposing the agency to risk. Outside counsel generally does the "heavy-lifting" under the guidance of in-house counsel.

The design of the closing should be detailed early on in the sales process. The smooth interaction between the program area, loan accounting and servicing, and legal counsel is key to a trouble-free closing.

11. Enter Post-Sale Management.

For a Portfolio Sale, there should be very little post-sale management required, unless SBA offered representations and warranties which give the buyer rights to put-back purchased assets or demand compensation. Such representations and warranties are generally to be avoided, and for these type of assets, in a Portfolio Sale, only "limited reps" should be offered (limited reps defined as: SBA owns the assets and SBA has the right to sell the assets). Retained Interest Sales should have the oversight mechanism fully designed and a part of the initial transaction. Transaction documents are available from RTC/FDIC which provide complete models for Retained Interest Sales and their oversight.

III. Cost Issues

No valuation costs are included in the expected costs of sale. With thorough and market-accessible due diligence, proper sales structure, and appropriate marketing, no separate "valuation" costs should be incurred with these sales events. The RTC focus eventually turned to accessible and complete due diligence coupled with thorough and proper marketing as the way to get the best price from the market, rather than investing limited time and dollar resources in determining what a particular pool of assets might be "worth". HUD worked on the same premise, with the one exception of broker's opinions of value that are obtained on the first lien single family mortgage collateral. It is assumed that the SBA assets have a varied collateral base consisting of business assets (such as leasehold improvements, plant, property, and equipment), personal assets (vehicles, planes, boats, etc.), and junior liens on real estate assets (residences, vacation homes, commercial properties, etc.). If the Program Financial Advisor is concerned about the quality, extent, accessibility, or presentation of the due diligence materials (and the concern cannot be remedied) or if there is some question about the sales structure, additional steps might then be considered to assist in getting a "value" for the loans to be sold. These steps might include broker's opinions of value on real estate assets, credit reports on guarantors, or D&B reports on obligor companies. In any event, it would seem that only a representative sampling should be necessary and that a valuation exercise on each asset in the portfolio would not be a prudent expense.

IV. Priorities in Selling SBA Portfolios

Several factors need to be considered in setting priorities for selling SBA portfolios:

- implications of budget scoring rules,
- the impact of sales upon SBA staff and the SBA organization, and
- lessons to be learned from each sale.

The direction to be implemented will be determined by SBA, in consultation with its Financial Advisors. The strategic planning team suggests the following priority for sales of SBA portfolios:

#1- <u>Portfolio</u>: Purchased and Direct 7(a) and 504 loans now serviced by approximately a dozen or more field offices, selected on the basis of (A) significant understaffing, compared to current workload, (B) stakeholder considerations, and (C) geographic optimization. The assets from these offices should be allocated first to the initial Portfolio Sale which will be the lead sales transaction of SBA. Once sufficient assets are designated for the initial Portfolio Sale, assets for the second transaction, the initial Retained Interest Sale, will be identified.

A promising option might be to include purchased collateral (Colpur) held by these twelve field offices in this portfolio as well, provided the Colpur is similar to that collateralizing the loans in the portfolio. Another option would be to include disaster business loans from the same areas in the initial transactions. However, such loans involve public policy considerations and are likely to require special approaches to servicing.

Rationale: Selection of overworked field offices reinforces the agency's commitment to minimize the personal and organizational disruption that otherwise might occur as a result of asset sales. The current servicing staff can be more easily reassigned after asset sales than would be the case in overstaffed offices.

Selection of the lowest quality portfolios for early sale helps to move into the private sector those assets that may benefit most from private servicing; such assets may provide the best opportunity for favorable budget treatment. Also, SBA may be able to benefit for budget purposes from the consequent increase in the average quality of its remaining portfolios.

However, the agency must ensure that the first sale is a huge success. The marketplace will scrutinize that first transaction and makes it decision about future participation. This would argue that the sale not be the worst assets in the portfolio, but rather be a portfolio that will maximize the full objectives of the agency. As to price alone, assets within the same geography will tend to maximize price more so than similar asset quality with geographic diversity.

Learnings: This sale would be used to launch the program and create the first successful sales event, to gain experience with due diligence and the quality of available information, and to begin the process of redeployment of SBA staff that previously serviced the sold loans.

#2- Portfolio: Sales of all performing and current SBA Serviced Section 7(a) and 504 direct loans.

Rationale: These seasoned loans appear to be the highest quality in the SBA portfolio. The volume of these direct loans is small compared to the workload of most offices that service them; this permits easier reallocation of staff. Because of the possible budget consequences of selling performing loans, this sale must follow the sale of lower quality assets.

Learnings: This sale permits SBA the best opportunity to test a bulk sale, and to examine the quality of loan information of higher quality loans than those sold in the first sale.

#3- Portfolio: Sales of 15 percent of performing direct disaster home loans, following the requirements of the recent legislation with respect to privatization of servicing of 30 percent of such loans. Two approaches should be evaluated: (1) representative sampling of disaster home loans with geographic diversity, and (2) sampling based on a geographic concentration and the Program Financial Advisor will make and justify a recommendation to SBA.

Rationale: The sale of loan assets is one way to privatize the servicing of those loans. However, asset sales may be a more useful and manageable way to accomplish such privatization. If the Congress approves, SBA may be able to set aside half of the loans to be privatized under the recent legislation and privatize them through asset sales. This will be especially cost-effective if the Congress intends eventually to sell those loans anyway.

The public policy issues associated with the sale of these assets must be resolved before the most effective structure can be recommended. There may be value to some stakeholders, like Congress or OMB, to see sales results from a representative sampling of the loans. On the other hand, HUD's recent (although limited) experience seems to support the conclusion that price can be maximized by selling on a geographic concentration.

Key step: To count the asset sales as privatization of servicing under the recent legislation, SBA will need to obtain the consent of the congressional committees that enacted the legislation.

Learnings: Conducting this sale would require SBA to clarify public policy purposes with respect to the disaster home loans. It also permits SBA to gain experience with due diligence and the quality of available information about the disaster home loan portfolio. As in all cases, education of the marketplace will be necessary to achieve the best price.

This approach also provides SBA with a comparison among effective use of private servicers, in-house SBA servicing, and outright sale.

#4- Portfolio: Sales of all purchased collateral (Colpur) held by SBA.

Rationale: Management and disposition of purchased assets is staff- intensive and arguably not closely related to the core mission of SBA. The financial advisor engaged to examine the portfolio and recommend sales events should look at the volumes and locations of the purchased collateral it may be appropriate to engage one of more auctioneers and liquidate quickly.

Learnings: This sale will permit SBA to alleviate a staff-intensive task, potentially gain experience with the private sector's abilities in auctioning business assets, and ascertain the quality of available information about the purchased collateral held by the agency.

#5- Portfolio: Sales of purchased 7(a) and 504 loans now serviced by all field offices other than those that are overstaffed for their current workloads.

Rationale: At this point, the asset sales program has hit its stride. The market will have experience with the value of the SBA assets. The agency will have had time to begin implementing the new mission that has been stated by the Administrator, with respect to monitoring of private lenders. Overstaffed offices will gain a deferral to permit personnel decisions to be made that carry out the agency's commitment to avoid RIFs.

Learnings: SBA will continue to refine its sales approaches and one would expect efficiencies in execution, now that the investor marketplace has gained experience with the agency, its assets, and its sales credibility.

#6- Portfolio: Selected portfolios of direct disaster home loans and direct disaster business loans. Sales of seasoned, performing disaster loans need to be conducted in accordance with the SBA's budget position with respect to asset sales during the fiscal year. Sales of nonperforming loans involve public policy issues that will have been tested in earlier sales.
Rationale: These loans have been deferred until late in the sales process. This is to permit the SBA to gain experience with the special private servicing requirements that may be needed to assure performance of the SBA's public mission with respect to these loans. Deferral until a late date also is consistent with the mandate from OMB.

Learnings: SBA will continue to refine its requirements for private servicing of these loans and, one hopes, will achieve a sound balance between financial returns to the government and the need to service these loans in accordance with public purposes.

V. Policy Issues in Loan Servicing

SBA provides financing to promote social objectives such as development of small business and aiding victims of declared disaster areas. Any unnecessary collection action that causes avoidable hardship for borrowers is generally considered inconsistent with those objectives. On the other hand, it is recognized that loan programs cannot long continue if debt goes unpaid. Failure to collect debts due from borrowers who default without true justification is an indirect punishment (and disincentive) for comparably situated borrowers who *are* paying their debts, often with great personal sacrifice. Ultimately, it is the taxpayer who is funding the program and who expects the Agency to achieve its overall performance and public purpose objectives.

Present Practice

Solving this conflict is now addressed through servicing policies and practices. That requires SBA staff to make difficult decisions about who is "deserving" and who is not; and those decisions have to be made one-by-one, meaning the staff time is intensive.

Applying present practice in the asset sale context is an option, but would be difficult, has no contractual standing, and is far from fool-proof. It is not realistic to expect purchasers of sold SBA loans to follow servicing that tracks the unwritten practices of effective SBA offices. Buyers will not have the practice or incentive of SBA public servants. Trying to overlay SBA decision making on buyers is inherently inconsistent with loan sales.

Legal Obligations

To the extent that concern for a borrower's situation has already resulted in a restructuring of the repayment obligation, loan purchasers must respect those modifications. That will be true regardless of the sale structures which are used.

Mandatory Collection Procedures

Reasonable loan servicing procedures can be imposed on loan buyers. Mandatory collection procedures including credit scoring and other techniques, may permit the separation of borrowers whose circumstances warrant special servicing from those whose loans should be serviced on commercial standards.

If the departures from commercial practices are too onerous, however, they will fly in the face of the financial incentives of the loan buyer and be difficult to enforce. Perhaps more important, they will significantly reduce financial return to SBA from asset sales. Also, mandatory procedures would apply equally to the undeserving borrower who is trying to "game the system" and to the truly needy. If the procedures are designed to fully protect the needy, they will wastefully benefit the undeserving. Mandatory rules may be more appropriate for special programs such as disaster assistance than for programs such as Section 7(a) loans, that are supposed to be provided on more of a businesslike basis.

> **NOTE:** It should also be noted that practices to serve public purposes, and that may be argued to reduce the sales price, must be cleared with OMB. In the discussions that will ensue about determining the credit reform impact of proposed sales, conditions of sale will be examined.

Other Options for Managing the Public Policy Responsibilities Inherent in SBA Programs

The strategic planning team has struggled with other options that may be employed to address the public policy issues in servicing. More work is needed in this area, which should follow a better understanding of the pros and cons with SBA representatives. One idea worth further exploration is to establish a fund to assist with hardships. Those hardships might be limited to homeowners facing foreclosure. Businesses should receive hardship assistance only for rare, fully-documented, special, unforeseeable circumstances.

The private investor is not best situated to administer the fund, as their expectation is to maximize financial returns rather than implement broad, discretionary public purpose objectives. The investor could identify a qualified non-profit or other organization not affiliated with the investor to carry out the public policy function of administering the hardship fund.

Another option would be for SBA staff to administer a fund directly. That would provide an opportunity to experiment with policy adjustments and may be a good opportunity to use staff reallocated from servicing of sold loans and Colpur. However, government administration of such a fund may give rise to a perception, regardless of the financial and legal realities, that SBA remains responsible for the loans after they are sold.

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